KPMG

Managing liquidity and volatility

A debt market update

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Life has changed, but not ended!

In the last 18 months we have witnessed a series of geopolitical changes – the UK's Brexit vote, a US election and the meteoric rise of Emmanuel Macron and his En Marche party. We then woke up on the 9th of June to the shock of Theresa May's Conservative party failing to retain a majority in the UK's House of Commons.

Political volatility is just one of a number of factors creating uncertainty in the international debt markets.

In this publication we examine how geopolitics and other market trends are currently impacting lender appetite, and consider how borrowers should prepare for the potentially choppy waters ahead.

The UK market

Appetite for investment grade paper has continued to be strong in 2017. After a bumper 2016 in the sterling bond market, we saw more than £3bn of bonds priced in the first 5 months of 2017 (source: Global Capital).

UK Gilts have tightened during the first half of the year and even following a spike in early July, yields remain lower than levels at the start of the year. The Bank of England's Quantitative Easing ("QE") Programme continues to mop up liquidity and support yields.

The deal activity in the leveraged market continues to be strong, with new high yield issuance of over €8.2bn to June 2017 (source: LCD), this represents a 70% increase on 2016 issuance (source: Moody's). The ferocious appetite for leveraged loan paper has driven the closing of over €6.1bn of deals over the same period (source: LCD).

Earlier this year, the market reacted to the belief that the higher inflationary environment was here to stay and that geopolitical volatility will begin to impact the real economy. However in the UK, lower than anticipated growth has meant that yields have stayed low for a prolonged period.

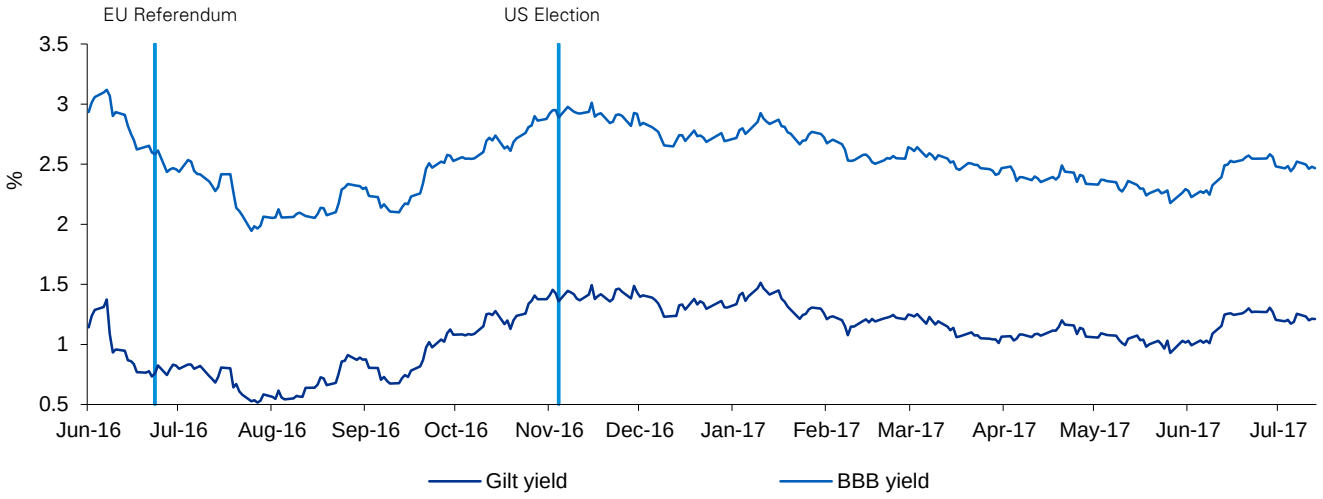
The corporate debt market has remained robust with local and overseas banks supporting domestic and international borrowers, buoyed by ongoing growth in the non-bank credit market.

However we are increasingly seeing signs of banks being more sector selective, cautious in their credit decision making and for the first time in years, applying upward pricing pressure.

"The UK credit market continues to enjoy previously unseen levels of liquidity ... an abundance of capital is presenting real opportunities to seek financing to fuel growth, support M&A activity or diversify financing strategy… geopolitical events over the last 12 months have not yet materially impacted on credit supply but I sense some conservatism amongst lenders as they look forward to the next few months"

Nick Dodd, Head of Debt Advisory UK

UK 10 year Gilt and BBB yield



Source: Eikon

European markets

The ECB has purchased over €1.8tn of assets (including €75bn of Corporate Bonds) over the last 2 years under its QE programme (source: BoE, FT). However, in April the Central Bank scaled back its monthly purchases from €80bn to €60bn until December 2018.

Growth has returned to the region, however we anticipate volatility will continue given factors such as the uncertainty of Brexit, the German elections and ongoing Greek debt negotiations. The bailout of two Italian banks at the end of June has also resulted in jumpiness across the European market.

The bond market has seen significant volatility over the first half of 2017 with periods of uncertainty and reluctance to issue followed by levels of bumper issuance, particularly following the French election and in the run up to the summer break.

There have also been bright spots such as a significant number of deals closed by US companies as they look to benefit from low underlying yields.

Despite the uncertainty of an election, confidence in German-issued debt has remained. 2016 saw a record of €25.8bn of corporate Schuldschein issuance and a 28% increase on 2015's equally record-setting €20.1bn of issuance, a trend that has continued into 2017.

In the bank market, 2017 YTD European loan volumes are up 13%, totalling $380bn. Over 53% of this new issuance has been linked to refinancing, dwarfing M&A volumes (source: LPC).

What's trending in the debt markets?

The dominance of banks threatened

Domestic and overseas banks continue to provide the majority of loan capital in the UK markets, and we expect banks will be the core source of financing for corporate borrowers for the foreseeable future.

However, the bank market is subject to tightening regulatory and capital adequacy requirements. The introduction of IFRS9 is forecast to increase both asset provisioning and capital requirements as it changes the rules on the impairment of financial assets.

The ultimate impact of the introduction of banks' retail asset ring fencing also remains to be seen.

We would expect that over time these dynamics, will put pressure on credit appetite, loan pricing and speed of decision making. We are already witnessing some signs of higher levels of scrutiny in certain sectors, coupled with inconsistent credit decisions.

Paradoxically for popular asset classes and sectors, increased competition continues to drive the tightening of loan margins.

However, receptiveness of lenders is not as strong as in recent years to support certain corporates who are looking to exercise flexibility in their existing facility documents (such as tenor extension or accordion features).

The growth of non-bank lending

The dynamics of the bank market provide a continued opportunity for the growth of credit alternatives.

Private debt funds have raised significant levels of liquidity in recent years. At the end of March 2017, Preqin reported over US$55bn of "dry powder" available in the European private debt market to be deployed over the next three years. This includes €9.1bn of fresh capital so far this year, almost matching the amount raised during the whole all of 2016 (source: Preqin).

Despite higher issuance volumes, the supply and demand dynamics still favour borrowers and the ongoing search for assets has led funds to:

— Offer more competitive pricing and creative structures, providing "off market" size, PIK notes and second lien structures

— More aggressively targeting outside the 'London Market', across the UK regions and continental Europe;

— Focus on niche sectors; and

— Team up with banks to provide hybrid structures

The funds have become particularly active in the leveraged finance market and there is likely to be a limit to how far the banks are prepared to follow. The recently issued ECB leverage guidelines may serve as a watershed in the competitiveness of the European leveraged finance banks.

Over time we expect the ongoing blurring of the traditional bank and non-bank lending markets to continue, as both show selective lending appetite, pricing differentials narrow and borrowers become more comfortable with non-bank lenders.

"The charge of the credit funds continues, the challenge for these lenders is to secure effective origination channels… and differentiate their product, price and approach …"

Peter Bate, Leveraged Finance Advisory

Real Estate

The number of players in the real estate market will continue to grow as a greater range of lenders seek sector niches. We particularly expect to see an increase in international banks lending in the UK.

The rise of dedicated credit funds is also impacting the sector particularly in development financing, as traditional lenders remain cautious and the number of participants willing to deploy capital is limited.

The non bank lenders also demonstrate more flexibility to move up and down the capital structure.

We expect pricing, leverage and covenant levels to continue to be more conservative than 2016 levels, principally reflecting the ongoing geopolitical volatility.

Funding working capital

In recent years we have witnessed increasing sophistication in funding products targeted at supporting working capital and supply chain, helping borrowers better manage the cycle and release cash.

This in turn has led to the growth of new entrants into the market who offer a range of bespoke products, often to a broader range of credit quality and a wider spectrum of sectors.

Supplier finance, receivables discounting, stock lending, reverse factoring and ABL can all be incorporated into a borrowers funding platform, acquisition and investment strategies.

This is a space to watch carefully as fintech solutions will provide even deeper credit appetite, diverse funding pools and challenge traditional products and providers.

Alternative listings

The EU's Market Abuse Regulation (MAR) is redefining execution processes and investor engagement as it requires issuers of securities to disclose extensive levels of information. The obligations quickly identified high yield bond issuers as those most likely to be affected, given they are often unlisted, mid-sized and leveraged borrowers who face challenges with the "cost" of compliance.

As a result, recent activity in the high yield bond market has seen a number of unlisted issuers choosing to list on alternative exchanges such as the Channel Islands, which is not subject to MAR.

Regulation is likely to adapt to capture these issuers, but in the meantime we are going to see borrowers utilise this and other exchanges to arbitrage the challenges of regulation.

There are new channels to explore and more caution being seen from banks

Uncertainty is in the air...

We expect markets to continue to be volatile in the medium term

Political dynamics

A major trend that defined political discourse in 2016 and one that appears likely to shape the political landscape in 2017 and beyond, is the apparent diminishing public support for globalisation.

It feels like a long time since the EU Referendum. Brexit negotiations finally kicked off on 19th June and uncertainty will continue to surround the divorce process with expatriate rights, access to the EU market, financial service passporting, migration controls (the list goes on) all leading to considerable unease for borrowers and lenders in the UK and across Europe.

The weakened pound has been one of the core contributors to the steady rise in UK inflation over the last 12 months and is expected to shift inflation higher in the medium term. The devaluation may have benefited the FTSE100 and inbound investment, however, the longer term impact on the UK economy and financial markets remains unclear.

Brexit and its impact on the pound has served to increase the appetite for UK investment and asset acquisition from international capital…the companies we work with love UK's stable, well regulated environment and offer both opportunities and challenges for domestic lenders"

Richard Dawson, Managing Director, Debt Advisory

China, China, China ...

For the first time in a number of years China has been knocked off the top of the charts as the most likely cause of global volatility.

2016 was relatively stable with GDP growth of 6.5% and it remains to be seen if this level can be sustained in 2017, given factors such as potential reduction in salary increases and house price inflation and falling liquidity in the domestic debt markets.

Chinese demand remains critical to the health of the global economy, periods of volatility and disruption will particularly impact the export driven economies.

The growth in levels of domestic consumption and increased risk of international trade conflict both have the ability to impact demand volumes.

The recent introduction of capital controls by the Chinese authorities, albeit temporary, have stalled a number of acquisitions and reduced outbound investment activity – China is still "going abroad", but we will watch deal volumes with interest in the medium term.

US growth

The US Federal Reserve is expected to act more hawkishly in the mid-term, as demonstrated by the latest interest rate rise in June. We will watch to see how the US reacts to inflation and the end of stimulus measures. History would suggest European central banks often follow similar shifts in fiscal policy.

The previously close relationship between gilts and US treasuries has started to break down post the Brexit vote, driven by a number of technical and fundamental factors, perhaps suggesting investors are nervous about the impact of Brexit on the British economy.

Banking regulations

Due to an increasingly restrictive regulatory environment, over time it will simply be more expensive for large banks to lend money.

The raft of increased regulatory and capital adequacy requirements (mentioned above), mean a likely outlook of more selective credit decision making and increased borrowing costs. On 27th June, the Bank of England raised its capital buffer to 0.5% of lending, which is expected to add c. £5.7bn to the capital requirement for British banks. (source: Reuters)

Consumer economy

There are signs that chill winds are starting to gather in the consumer credit market, with the Bank of England recently requiring banks to demonstrate how they are addressing concerns about the increasing riskiness of their lending.

Many commentators believe, an increasing consumer appetite for credit cards, unsecured loans and car financing is conspiring to cause a headache that could potentially develop into something more serious over the months ahead.

Borrowers need to be proactive in uncertain times ...

There remains opportunities for well-prepared borrowers to achieve "top of the market" terms and diversify their funding sources, however the level of market edginess is such that these attractive market conditions are unlikely to continue indefinitely.

Not only are the debt markets showing signs of caution, there are some initial pointers to stress in the wider consumer finance environment. There are also signs that current financing dynamics are beginning to pose strains on certain sectors.

Sterling depreciation, wage deflation and supply chain pressures also have the potential to impact the health of your key suppliers and customers.

This is a critical time to assess your funding arrangements and financing strategy in light of trading conditions and potential cash pressures.

We are currently helping clients to evaluate:

— The impact on profitability of the rising cost of funding;

— Upcoming maturities and impact of potential carry costs against difficulty in predicting medium term market behaviour;

— The benefits of extending tenor, increasing available headroom and diversifying sources of borrowing to mitigate future shifts in the markets;

— The credit dynamics and performance of key suppliers, customers and other stakeholders; and

— The best approach and market strategies for getting on the front foot and addressing potential credit concerns.

It is critical that borrowers actively prepare for bumps in the road by closely monitoring the developments in the debt markets and proactively managing their lending relationships.

How KPMG can help

The bank market, the public and private institutional markets, non-bank credit funds and working capital options all provide borrowers with a breadth of borrowing alternatives and opportunities. The level of choice can be challenging.

KPMG's Debt Advisory Group provides financing strategy and fund raising advice to a range of large and mid-market corporates and financial institutions.

We have debt advisory teams based in each of the global financial centres and 30 professionals based in the UK ready to help borrowers navigate the dynamic market environment in order to support the right financing choices to drive growth.

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